Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author: Chesbro | Analyst: Marion Mann DeJong | Bill Number: SB 93

Related Bills: AB 1469 (1998) | Telephone: 845-6979 | Amended Date: 02/11/1999

Attorney: Doug Bramhall | Sponsor:

SUBJECT: Taxpayer Bill of Rights/Conformity

_____ DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended __________.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

_____ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended __________.

_____ FURTHER AMENDMENTS NECESSARY.

_____ DEPARTMENT POSITION CHANGED TO __________________________.

_____ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED__________, STILL APPLIES.

x OTHER - See comments below.

SUMMARY OF BILL

This bill would conform to federal technical changes relating to Roth individual retirement accounts (Roth IRAs) included in the Internal Revenue Service Restructuring and Reform Act of 1998 (IRS Reform Act).

SUMMARY OF AMENDMENTS

The February 4, 1999, amendments deleted obsolete refund provisions related to the renter's credit that are no longer necessary, modified the Roth IRA election provision, changed various operative dates and intent language, and made minor technical changes.

The February 11, 1999, amendments deleted all provisions of the bill except for the Roth IRA provisions. The amendments also modified the Roth IRA election so that the federal election made by taxpayers to include the entire amount of gain from a Roth IRA rollover in their 1998 income is binding for state purposes.

The following analysis replaces the analysis of the bill as introduced December 7, 1998.

OPERATIVE DATE

The bill specifies that it would be operative for taxable years beginning on or after January 1, 1998.

Board Position:

_____ S _____ NA _____ NP
_____ SA _____ O _____ NAR
_____ N _____ OUA X PENDING

Department Director: **Gerald Goldberg** Date: **2/25/1999**

BACKGROUND

Beginning in 1998, **federal and California law** provide for a new type of IRA, called a Roth IRA. A Roth IRA differs from other IRAs in that the tax advantages are "backloaded." Contributions to a Roth IRA are not tax deductible. Instead, the IRA earnings (e.g., interest and dividends) are distributed tax-free (provided that certain requirements are met). To be treated as a Roth IRA, the account must be designated as such when it is established. Unlike other IRAs, an individual may make contributions to a Roth IRA beyond the individual's age of 70½.

Distributions from a Roth IRA are not included in gross income and are not subject to the 10% early withdrawal tax if certain requirements are met. In addition to other requirements, the individual must have held the Roth IRA for a five-year period beginning with the first year in which a contribution was made to the Roth IRA and ending with the end of the fifth year after the contribution.

Additionally, holders of a Roth IRA do not need to start receiving distributions by the age of 70½, as do holders of other types of IRAs.

Federal and California law also permit the "rollover" of a non-Roth IRA into a Roth IRA if the taxpayer's AGI for the year does not exceed $100,000 (computed without regard to the rollover distribution) and the taxpayer is not a married individual filing a separate return. The $2,000 annual contribution limit does not apply to rollovers. The rollover of an ordinary IRA into a Roth IRA requires the taxpayer to report the ordinary IRA distribution in gross income. However, if the ordinary IRA is contributed to the new Roth IRA within 60 days of the distribution, the 10% early withdrawal tax will not apply. If an ordinary IRA is rolled into a Roth IRA before January 1, 1999, the amount of gain that is includible in gross income is included ratably over a four-year period. The law permits a rollover into or between Roth IRAs more than one time a year.

LEGAL RULINGS

In 1998, Franchise Tax Board issued two legal rulings regarding Roth IRAs.

Legal Ruling 98-3 provides rules regarding the taxation of IRA distributions rolled over to a Roth IRA in 1998 followed by a change in residence status.

Legal Ruling 98-4 provides that for the 1998 taxable year, a taxpayer who makes a trustee-to-trustee transfer from a federally designated Roth IRA that recharacterizes contributions to the Roth IRA for federal purposes, such transfer shall be treated as designating the Roth IRA as a traditional IRA for California tax purposes. As a result, taxpayers that recharacterize a contribution to a Roth IRA will be treated the same for California purposes.

SPECIFIC FINDINGS

The **IRS Reform Act** made technical changes in the following seven areas of the Roth IRA provisions:

1. Early Withdrawals of Amounts Converted From Regular IRAs to Roth IRAs. Under the law before the IRS Reform Act, (1) the four-year income spread was mandatory, not elective, and (2) the 10% tax on early withdrawals did not apply to conversions of regular IRAs into Roth IRAs. Thus, under **federal law** before this change, taxpayers under age 59½ could escape the 10% early withdrawal penalty tax by rolling over funds from a regular IRA to a Roth IRA and then immediately thereafter taking a distribution from the Roth IRA.

The **IRS Reform Act** modifies the rules relating to conversions of regular IRAs into Roth IRAs in order to prevent taxpayers from receiving premature distributions from a Roth Conversion IRA while retaining the benefits of the four-year income spread as follows:

- Acceleration of income inclusion. Where amounts are converted in 1998, and are thus subject to the four-year income spread, income inclusion is accelerated for any amounts withdrawn before 2001, the fourth year of the spread. This is done by adding the amount withdrawn in that year to the amount required to be included in income in that year under the four-year income spread rule. However, a limitation to the inclusion rule is provided to prevent more than the total amount required to be included in income over the four-year period from being included in income.

- Election. The **IRS Reform Act** makes the four-year income spread elective. Once made, the election or non-election cannot be changed.

- Application of early withdrawal tax to converted amounts. If converted amounts are withdrawn within the five-year period beginning with the year of the conversion, the amount withdrawn, only to the extent attributable to amounts that were includible in income due to the conversion, will be subject to the 10% early withdrawal tax.

2. Determination of Five-Year Holding Period. Under the law before the IRS Reform Act change, the five-year holding period with respect to conversion of Roth IRAs began with the tax year of the conversion.

- Applying the five-year holding period for Roth IRAs. The **IRS Reform Act** eliminates the special rule under which a separate five-year holding period begins for purposes of determining whether a distribution of amounts attributable to a conversion is a qualified distribution. Thus, the five-year holding period rule for Roth IRAs will begin with the year for which a contribution is first made to a Roth IRA. A subsequent conversion will not start the running of a new five-year period.

- Return of excess contributions. Distributions of excess contributions and earnings allocable to the contributions are not considered qualified distributions.

- Ordering rules. Ordering rules are provided to determine which amounts are withdrawn in the event a Roth IRA contains both conversion amounts (possibly from different years) and other contributions. Under these rules, regular Roth IRA contributions will be deemed to be withdrawn first, then converted amounts (starting with the amounts first converted).

Withdrawals of converted amounts will be treated as coming first from converted amounts that were includible in income. Earnings will continue to be treated as withdrawn after contributions. For purposes of these rules, all Roth IRAs (regardless of whether maintained in separate accounts) are considered a single Roth IRA.

3. Corrections of Erroneous Conversions. Under the law before the IRS Reform Act change, no mechanism allowed a taxpayer to correct or “undo” an erroneous conversion, such as when a taxpayer makes a conversion early in a tax year and then discovers by the end of the year that the AGI limit of $100,000 has been exceeded and, thus, the taxpayer is ineligible to make the conversion.

The **IRS Reform Act** provides that contributions to an IRA and earnings on those contributions may be transferred in a trustee-to-trustee transfer from any IRA to another IRA by the due date for the taxpayer’s return for the year of the contribution (including extensions). Any transferred contributions will be treated as if contributed to the transferee IRA and not to the transferor IRA. Any transfer of contributions must be accompanied by any net income allocable to the contributions. Also, these transfers are permitted only if no deduction was allowed with respect to the contribution to the transferor plan. These provisions are effective for tax years beginning after December 31, 1997.

4. Effect of Account Holder’s Death during Four-Year Spread Period. The **IRS Reform Act** provides that any amounts remaining to be included in income as a result of a 1998 conversion (the four-year spread) will be includible in income on the final return of the deceased taxpayer. If the surviving spouse is the sole beneficiary of the Roth IRA, the spouse may elect to continue the deferral by including the remaining amounts in his or her income over the remainder of the four-year period. However, that election may not be made or changed after the due date for the spouse’s tax year that includes the date of death.

5. Determination of AGI Limit for Conversions. The **IRS Reform Act** provides that AGI, for purposes of applying the $100,000 threshold, is determined in the same manner as for regular IRAs. For regular IRAs, AGI includes taxable social security and railroad retirement benefits and the application of the passive activity loss rules. However, the exclusions for interest on U.S. savings bonds used to pay higher education expenses, for employer-provided adoption assistance programs, and for foreign earned income are not taken into account in determining AGI. In addition, the deduction for a contribution to a regular IRA is not taken into account.

The **IRS Reform Act** also makes it clear that the applicable AGI is the AGI for the year of the distribution to which the conversion relates. It also clarifies that, for purposes of computing taxable income, the conversion amount is to be taken into account in computing all AGI-based phase-out amounts except for the modified AGI amount used in Roth IRA conversions.

6. Clarification of Phase-out Range. The $2,000 Roth IRA maximum contribution limit is phased out for individual taxpayers with AGI between $95,000 and $110,000 and for married taxpayers filing a joint return with AGI between $150,000 and $160,000. The **IRS Reform Act clarifies** that the phase-out range for the Roth IRA maximum contribution limit for a married individual filing a separate return is $0 to $10,000 of AGI.

7. Clarification of Contribution Limit. The **IRS Reform Act** clarifies that the maximum amount of contributions an individual may make to all of his or her IRAs is limited to a cumulative total of $2,000 per year.

The **IRS Reform Act** also provides that a simplified employee pension (SEP) or a SIMPLE IRA may not be designated as a Roth IRA and contributions to a SEP or SIMPLE IRA cannot be taken into account for purposes of the $2,000 contribution limit. Thus, contributions to a SEP or SIMPLE IRA will not affect the amount that an individual can contribute to a Roth IRA.

All provisions contained in the IRS Reform Act that affect Roth IRAs have an operative date for federal law for tax years beginning after December 31, 1997.

California law is in conformity with federal law as it relates to Roth IRAs prior to the enactment of the IRS Reform Act. Additionally, California law provides that the early withdrawal tax applied to converted amounts withdrawn within the five-year period beginning with the year of conversion.

This bill would conform to the IRS Reform Act technical changes relating to the Roth IRA provisions discussed above. The bill would make the federal election by a taxpayer to include the entire amount of gain from a Roth rollover in their 1998 income binding for state purposes. The federal election made by a surviving spouse would also be binding for state purposes.

<u>Implementation Considerations</u>

Implementation of this bill would not be problematic. The 1998 tax forms refer taxpayers with Roth IRAs to FTB Publication 1005A. This publication explains the current law differences between federal and state law for Roth IRAs. The publication indicates that pending legislation (this bill) may conform state law to federal law and provides Internet sites and telephone numbers that the taxpayer may use to obtain further, up-to-date information.

<u>FISCAL IMPACT</u>

<u>Departmental Costs</u>

This provision would not significantly impact the department’s costs.

<u>Tax Revenue Estimate</u>

This bill would conform to seven changes made in federal law that are, for the most part, technical and would affect a relatively small number of taxpayers. In addition, some of the changes would result in revenue gains while others would result in revenue losses. Thus, it is expected that conforming to the federal changes would result in unknown, but probably minor net impacts on state revenue.

<u>Tax Revenue Discussion</u>

The first item, making elective the four-year spread of amount rolled during 1998, would accelerate some revenue into the first year from the second through fourth years after conversion. Potentially offsetting the gains would be that taxpayers with business losses in the first year could use those losses to offset the realized gain from the IRA conversion.

Absent this bill, some of those taxpayers could be forced to discount the losses by half and carry them forward as NOL's to be applied against income in subsequent years. To the extent this happens, this provision would result in revenue losses in the out years without corresponding gains in the initial year.

The second item, clarifying that the five-year holding period begins with the initial conversion, would result in a loss of penalties that might have otherwise been levied. This provision is expected to affect very few taxpayers.

The third item, allowing recharacterization of conversions, would result in unknown revenue losses. This change has been accomplished for 1998 only via a legal ruling. This bill would make the correction permanent.

The fourth item, clarifying that in the event of death during the four-year spread of rollovers, remaining amounts would be included in income in the year of death, would result in unknown, but minor acceleration of revenue for single taxpayers. However, since surviving spouses may elect to continue the four-year spread, it is unlikely there would be acceleration of revenue for surviving spouses.

The fifth, sixth and seventh items, clarifying definitions of AGI, the income phase-out range, and limitations on contribution amounts, would result in insignificant revenue impacts.

BOARD POSITION

Pending.